



Report of Independent Auditors and  
Financial Statements for

## Kaua'i Island Utility Cooperative

December 31, 2010 and 2009

**MOSS-ADAMS<sub>LLP</sub>**

Certified Public Accountants | Business Consultants

*Acumen. Agility. Answers.*

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## REPORT OF INDEPENDENT AUDITORS

To the Board of Directors  
Kaua'i Island Utility Cooperative

We have audited the accompanying balance sheets of Kaua'i Island Utility Cooperative (the Cooperative) as of December 31, 2010 and 2009 and the related statements of operations, equities and margins and cash flows for the years then ended. These financial statements are the responsibility of the Cooperative's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Cooperative's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Cooperative as of December 31, 2010 and 2009 and the results of its operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated April 14, 2011 on our consideration of the Cooperative's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in conjunction with this report in considering the results of our audit.

Moss Adams LLP

Portland, Oregon  
April 14, 2011

**KAUA'I ISLAND UTILITY COOPERATIVE  
BALANCE SHEETS**

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**ASSETS**

	<b>December 31,</b>	
	<b>2010</b>	<b>2009</b>
<b>UTILITY PLANT</b>		
Electric plant in service	\$ 396,023,652	\$ 385,098,649
Electric plant acquisition cost	54,852,453	54,852,453
Accumulated depreciation and amortization	<u>(221,234,482)</u>	<u>(211,674,481)</u>
Net electric plant in service	229,641,623	228,276,621
Construction work in progress	<u>11,789,712</u>	<u>13,463,888</u>
Net utility plant	<u>241,431,335</u>	<u>241,740,509</u>
<b>OTHER PROPERTY AND INVESTMENTS</b>		
Investments in associated organizations	609,781	577,573
Rural economic development loans	<u>636,961</u>	<u>683,911</u>
Total other property and investments	<u>1,246,742</u>	<u>1,261,484</u>
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	5,622,851	2,493,692
Restricted cash and cash equivalents	463,644	415,117
Accounts and notes receivable, less allowance for doubtful accounts of \$711,029 and \$1,176,683 in 2010 and 2009, respectively	9,269,876	10,371,736
Accrued unbilled revenue	8,167,434	7,275,331
Energy rate adjustment clause	424,951	476,962
Inventories	14,217,398	13,320,441
Other current and accrued assets	<u>964,439</u>	<u>1,205,932</u>
Total current assets	<u>39,130,593</u>	<u>35,559,211</u>
<b>DEFERRED DEBITS</b>	<u>6,335,290</u>	<u>5,889,530</u>
<b>TOTAL ASSETS</b>	<u><u>\$ 288,143,960</u></u>	<u><u>\$ 284,450,734</u></u>

**KAUA'I ISLAND UTILITY COOPERATIVE**  
**BALANCE SHEETS**

**LIABILITIES AND EQUITIES**

	<b>December 31,</b>	
	<b>2010</b>	<b>2009</b>
<b>EQUITIES AND MARGINS</b>	<b>\$ 60,918,555</b>	<b>\$ 52,268,377</b>
<b>LONG-TERM DEBT, less current maturities</b>	<b>188,520,589</b>	<b>192,820,610</b>
<b>POST-RETIREMENT BENEFIT OBLIGATION</b>	<b>1,980,600</b>	<b>2,383,566</b>
<b>COMMITMENTS AND CONTINGENCIES (NOTE 11)</b>	<b>_____</b>	<b>_____</b>
<b>CURRENT LIABILITIES</b>		
Current maturities of long-term debt	9,261,000	8,875,500
Line of credit	-	2,000,000
Accounts payable	7,337,948	7,438,615
Consumer deposits	1,048,833	1,137,879
Accrued employee compensation	2,125,643	2,074,421
Accrued taxes	7,203,240	4,947,846
Other current and accrued liabilities	119,278	123,618
Total current liabilities	<b>27,095,942</b>	<b>26,597,879</b>
<b>DEFERRED CREDITS</b>	<b>9,628,274</b>	<b>10,380,302</b>
<b>TOTAL LIABILITIES AND EQUITIES</b>	<b>\$ 288,143,960</b>	<b>\$ 284,450,734</b>

**KAUA'I ISLAND UTILITY COOPERATIVE**  
**STATEMENTS OF OPERATIONS**

	Years Ended December 31,				Increase (Decrease)
	2010		2009		
	Amount	%	Amount	%	
<b>OPERATING REVENUES</b>					
Residential	\$ 58,599,648	37.8	\$ 48,759,893	37.6	\$ 9,839,755
Irrigation	35,886	0.0	264,087	0.2	(228,201)
Commercial and industrial	95,078,517	61.2	79,315,279	61.2	15,763,238
Public street and highway lighting	1,381,050	0.9	1,160,789	0.9	220,261
Other operating revenues	158,942	0.1	161,387	0.1	(2,445)
Total operating revenues	155,254,043	100.0	129,661,435	100.0	25,592,608
<b>OPERATING EXPENSES</b>					
Power cost	86,812,636	55.9	68,593,626	52.9	18,219,010
Transmission – operation	398,664	0.3	345,432	0.3	53,232
Transmission – maintenance	672,808	0.4	684,509	0.5	(11,701)
Distribution – operation	1,322,158	0.9	1,350,684	1.0	(28,526)
Distribution – maintenance	2,534,584	1.6	2,294,719	1.8	239,865
Customer accounts	2,511,538	1.6	2,307,997	1.8	203,541
Customer service and information	706,946	0.5	888,082	0.7	(181,136)
Administrative and general	14,152,002	9.1	11,267,733	8.7	2,884,269
Depreciation and amortization	14,595,414	9.4	16,736,333	12.9	(2,140,919)
Taxes	13,047,862	8.4	10,938,606	8.4	2,109,256
Other interest expense	163,876	0.1	81,679	0.1	82,197
Total operating expenses	136,918,488	88.2	115,489,400	89.1	21,429,088
<b>OPERATING MARGINS, before interest</b>	18,335,555	11.8	14,172,035	10.9	4,163,520
<b>INTEREST ON LONG-TERM DEBT</b>	9,061,322	5.8	9,502,337	7.3	(441,015)
<b>OPERATING MARGINS</b>	9,274,233	6.0	4,669,698	3.6	4,604,535
<b>NONOPERATING MARGINS</b>					
Interest income	637,917	0.4	785,863	0.6	(147,946)
Capital credits	40,015	0.0	39,725	0.0	290
Other nonoperating income	3,957	0.0	78,471	0.1	(74,514)
Total nonoperating margins	681,889	0.4	904,059	0.7	(222,170)
<b>NET MARGINS</b>	9,956,122	6.4	5,573,757	4.3	\$ 4,382,365
<b>COMPREHENSIVE INCOME</b>					
Unrealized loss on available-for-sale securities	-		(55,742)		
Post-retirement benefit obligation gain	150,866		2,511,334		
<b>COMPREHENSIVE INCOME</b>	\$ 10,106,988		\$ 8,029,349		

**KAUA'I ISLAND UTILITY COOPERATIVE  
STATEMENTS OF EQUITIES AND MARGINS**

	<b>Years Ended December 31,</b>	
	<b>2010</b>	<b>2009</b>
<b>Memberships</b>		
Balance at January 1,	\$ 391	\$ 371
Additions	18	20
Balance at December 31,	409	391
<b>Patronage capital</b>		
Balance at January 1,	51,316,308	48,191,014
Transfer of net margins	9,956,122	5,573,757
Retirement of capital credits, net	(1,516,774)	(2,448,463)
Balance at December 31,	59,755,656	51,316,308
<b>Unrealized gain (loss) on available-for-sale investments</b>		
Balance at January 1,	-	55,742
Loss	-	(55,742)
Balance at December 31,	-	-
<b>Other equity</b>		
Balance at January 1,	61,044	41,340
Additions	59,946	19,704
Balance at December 31,	120,990	61,044
<b>Post-retirement benefit obligation gain (loss)</b>		
Balance at January 1,	890,634	(1,620,700)
Gain	150,866	2,511,334
Balance at December 31,	1,041,500	890,634
<b>TOTAL EQUITIES AND MARGINS</b>	<b>\$ 60,918,555</b>	<b>\$ 52,268,377</b>

**KAUA'I ISLAND UTILITY COOPERATIVE**  
**STATEMENTS OF CASH FLOWS**

	<b>Years Ended December 31,</b>	
	<b>2010</b>	<b>2009</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net margins	\$ 9,956,122	\$ 5,573,757
Adjustments to reconcile net margins to net cash from operating activities		
Depreciation and amortization	14,914,143	17,105,515
Capital credits allocated	(40,015)	(39,725)
Change in assets and liabilities		
Accounts and notes receivable and unbilled revenue	209,757	(769,584)
Energy rate adjustment clause	52,011	(3,440,559)
Inventories and other current and accrued assets	(655,464)	(250,319)
Deferred debits	(445,760)	(1,468,950)
Post-retirement benefit obligation	(252,100)	(133,700)
Accounts payable, consumer deposits and accrued expenses	2,112,563	(3,214,506)
Deferred credits	(752,028)	(2,683,322)
Net cash from operating activities	<u>25,099,229</u>	<u>10,678,607</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Additions to utility plant, net	(14,604,969)	(18,813,417)
Rural economic development loans	46,950	9,262
Other property and investments	7,807	2,037,894
Net cash from investing activities	<u>(14,550,212)</u>	<u>(16,766,261)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Payments on long-term debt	(3,914,521)	(14,241,572)
Net activity on line of credit	(2,000,000)	2,000,000
Memberships	18	20
Other equity	59,946	19,704
Retirement of patronage capital	(1,516,774)	(2,448,463)
Net cash from financing activities	<u>(7,371,331)</u>	<u>(14,670,311)</u>
<b>CHANGE IN CASH AND CASH EQUIVALENTS</b>	3,177,686	(20,757,965)
<b>CASH AND CASH EQUIVALENTS, beginning of year</b>	<u>2,908,809</u>	<u>23,666,774</u>
<b>CASH AND CASH EQUIVALENTS, end of year</b>	<u>\$ 6,086,495</u>	<u>\$ 2,908,809</u>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>		
Cash paid during the year for:		
Interest on long-term debt	<u>\$ 9,061,322</u>	<u>\$ 9,502,337</u>
Income taxes	<u>\$ 4,114</u>	<u>\$ 47,890</u>



**NOTE 1 – NATURE OF ORGANIZATION AND OPERATIONS**

Kaua'i Island Utility Cooperative (KIUC or the Cooperative), a not-for-profit cooperative association pursuant to the provisions of Chapter 421C of the Hawaii Revised Statutes, was formed to purchase and operate the electric utility on the island of Kaua'i, Hawaii. KIUC is the exclusive retail electric service provider for the island of Kaua'i and provides electric generation, transmission and distribution services to approximately 36,000 customers. The Cooperative's headquarters facility is located in Lihue, Hawaii.

On November 1, 2002, the Cooperative acquired substantially all of the assets of Kaua'i Electric (KE), a division of Citizens Communications Company (Citizens). The aggregate purchase price was approximately \$218 million, which included transaction costs incurred in the acquisition, and was financed by lines of credit from the National Rural Utilities Cooperative Finance Corporation and loans from the U.S. government.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of accounting and presentation** – The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America as applied to regulated enterprises, which conform to policies prescribed or permitted by the Hawaii Public Utilities Commission (HPUC) and the United States Department of Agriculture, Rural Utilities Service (RUS).

The accounting records of the Cooperative are maintained in accordance with the Uniform System of Accounts as prescribed by the Federal Energy Regulatory Commission (FERC) for Class A and B electric utilities.

**Regulatory accounting** – Due to regulation of its rates by the HPUC, the Cooperative follows regulatory accounting requirements. Regulatory accounting requirements recognize that the ratemaking process can result in differences in the application of generally accepted accounting principles between regulated and non-regulated businesses. Such differences generally involve the accounting period in which various transactions enter into the determination of net margins. Accordingly, certain costs and income may be capitalized as a regulatory asset or liability that would otherwise be charged to expense or revenues. Regulatory assets and liabilities are recorded when it is probable that future rates will permit recovery and are approved by the HPUC (See Notes 6 and 10). Such balances are amortized over the period specified by the HPUC.

In accordance with an HPUC Decision & Order, KIUC is allowed recovery of depreciation expense not realized due to the early retirement of an electric plant destroyed in hurricane Iniki. In 1996, the HPUC approved \$7,598,760 as the total amount of Iniki deferred depreciation with an amortization period of 26 years. The annual amortization amount is \$292,260 ending in 2022. The Iniki regulatory asset is amortized to depreciation expense and the offsetting Iniki regulatory liability is amortized to accumulated depreciation.

**Membership** – In accordance with KIUC's bylaws, all electricity users can elect whether or not to become a member. Each member is entitled to one vote regardless of billing amounts.

## KAUA'I ISLAND UTILITY COOPERATIVE

### NOTES TO FINANCIAL STATEMENTS

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#### NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (continued)

**Patronage capital** – Net margins are assigned to individual Cooperative members' capital credit accounts based upon their pro rata use of total Cooperative electricity provided for the year (see Note 7). Capital credits are returned to members in accordance with the Cooperative's policies. Under the provisions of the mortgage agreements, until the equities and margins equal or exceed 30% of the total assets of the Cooperative, the return to patrons of capital contributed by them is limited generally to 25% of the patronage capital or margins received by the Cooperative in the prior calendar year. The equities and margins of the Cooperative represent 21.14% of the total assets at December 31, 2010. Under the provisions of the 2010 HPUC approved rate case, subject to the loan agreements, KIUC is required to return patronage capital for amounts exceeding a 2.00 TIER in a given year.

**Electric plant, acquisition cost, depreciation and maintenance** – Electric plant is stated at the original cost of construction, which includes the cost of contracted services, direct labor and materials and overhead items (see Note 3). Contributions from others toward the construction of electric plant are credited to the applicable plant accounts.

In accordance with RUS accounting regulations, electric plant acquisition cost represents the difference between the purchase price for the acquisition of KE's assets and the carrying value of those assets. This amount is being amortized over the remaining useful life of the assets acquired which was originally estimated to be 25 years.

Provision has been made for depreciation of electric plant at a straight-line composite rate of approximately 3.3% per annum. A depreciation study was conducted in March 2009 and was approved by the HPUC in 2010. The effective date of the new depreciation rates was June 1, 2010. Depreciation for the years ended December 31, 2010 and 2009 was \$14,914,143 and \$17,105,515, respectively, of which \$14,595,414 and \$16,736,333 was charged to depreciation and amortization expense and \$318,729 and \$369,182 was allocated to other accounts, respectively.

When property which represents a retirement unit is replaced or removed, the average cost of such property as determined from the continuing property records is credited to electric plant and such cost, together with cost of removal less salvage, is charged to the accumulated provision for depreciation.

Maintenance and repairs, including the renewal of minor items of plant not comprising a retirement unit, are charged to the appropriate maintenance accounts, except that repairs of transportation and service equipment are charged to clearing accounts and redistributed to operating expense and capital accounts.

Management assesses impairment and the existence of asset retirement obligations annually and as circumstances warrant.

**Investments in associated organizations** – Investments in associated organizations are carried at cost (see Note 4), which approximates fair value, plus capital credits allocated and not retired.

**KAUA'I ISLAND UTILITY COOPERATIVE**  
**NOTES TO FINANCIAL STATEMENTS**

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**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (continued)**

**Rural economic development loans** – The Cooperative has received Rural Economic Development Grants (RED Grant) from the USDA Rural Development (USDA RD) Office in order to provide loans to promote sustainable rural economic development and job creation projects. KIUC is required to match 20% of the RED Grant award. The RED Grant is awarded to KIUC, who in turn loans the funds to the eligible project applicant at 0% interest for a term of up to 10 years. When the loan recipient repays the loan, the loan funds are retained and placed into the Revolving Loan Fund (RLF) and then reused to fund new loans to additional projects (RLF Loans). The RLF Loans are made in accordance with the USDA RD approved Revolving Loan Fund Plan Loan Policies and Procedures Manual. Both the RED Grant loans and the RLF loans are stated at cost (see Note 4).

**Cash equivalents** – The Cooperative considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

**Restricted cash** – Cash restricted for rural economic development loans.

**Accounts and notes receivable** – Accounts and notes receivable are recorded when invoices are issued and are written off when they are determined to be uncollectible. The allowance for doubtful accounts is estimated considering the Cooperative's historical losses, review of specific problem accounts, existing economic conditions and the financial stability of its customers, currently 0.1% of monthly operating revenues. Generally, the Cooperative considers accounts receivable past due after 44 days.

**Inventories** – Materials and supplies inventories consist primarily of items for construction and maintenance of electric plant and are valued at average unit cost. Fuel inventories consist of naphtha and diesel fuel for the generation units and are valued at lower of cost or current market (see Note 5).

**Accrued vacation** – The Cooperative accrues accumulated unpaid vacation as the obligation is incurred. Compensated absences are included in "accrued employee compensation."

**Customer advances for construction** – Customer advances for construction represent advances for construction jobs that the customer requested, such as line extensions. The customer advance is held in a deferred credit account until the requirements have been met, at which time the advance, or applicable proportion of the advance, is refunded. If the requirements are not met within a 5-year time period, the advance is forfeited by the customer and credited to electric plant.

**Overhaul accounting** – In accordance with an HPUC Decision & Order, KIUC accrues for overhaul costs on the generation equipment by charging a proportion of the estimated cost of the overhaul, over the period covered by the overhaul cycle, to maintenance expense. The overhaul cycle for the individual generation units vary based on the type of unit and hours of use. For most generation units, the typical overhaul cycle is every 2 to 5 years. When the overhaul occurs, the actual costs are charged against the overhaul deferred credit (regulatory liability – scheduled plant maintenance), with any leftover being charged to maintenance expense (see Note 10).

## KAUA'I ISLAND UTILITY COOPERATIVE

### NOTES TO FINANCIAL STATEMENTS

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#### NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (continued)

**Post-retirement benefits** – KIUC sponsors a Retiree Welfare Benefit Plan (the Plan). The Cooperative accounts for the Plan by reporting the current economic status (the overfunded or underfunded status) of the plan in the balance sheet and measuring the plan assets and plan obligations as of the balance sheet date (see Note 13).

**Taxes** – The Cooperative is exempt from federal income taxes under the provisions of Section 501(c)(12) of the Internal Revenue Code, except to the extent of unrelated business income, if any. Effective January 1, 2009, the Cooperative adopted FASB Accounting Standards Codification (ASC) 740-10, relating to accounting for uncertain tax positions. As of December 31, 2010 and 2009, the Cooperative does not have any uncertain tax positions. The Cooperative files an exempt organization tax return in the U.S. federal jurisdiction and is no longer subject to examination by taxing authorities before 2007.

KIUC is not exempt under Hawaii Revised Statutes from state income taxes; however, margins that are allocated within a specific time period are considered a deduction for state income tax purposes. For the State of Hawaii, KIUC is assessed a 5.885% of gross revenues PSC Tax in lieu of general excise taxes and county real property taxes. Also, KIUC is assessed a 0.5% of gross revenues PUC Fee. For the County of Kaua'i, Hawaii, KIUC is assessed a 2.5% franchise fee on gross revenues.

**Electric revenues and unbilled revenue** – KIUC recognizes revenues based on rates (tariffs) authorized by the HPUC including unbilled revenue, revenue from electric power delivered but not yet billed to the customers.

The Cooperative's tariffs for electric service include energy rate adjustment clauses under which billings to customers are adjusted to reflect changes in the cost of fuel. In order to match power costs and related revenues, under-collected or over-collected power costs to be billed or credited to consumers in subsequent periods is recognized as a current asset or current liability and as an increase or decrease of classified operating revenues on the statement of operations.

**Cushion of credit** – RUS established a Cushion of Credit Payment Program, whereby borrowers may make advance payments on their RUS and FFB notes. These advance payments earn interest at the rate of 5.0% per annum. The advance payments, plus any accrued interest, can only be used for the payment of principal and interest on the notes. The Cooperative's participation in the Cushion of Credit Payment Program totaled approximately \$10.2 million and \$15.1 million at December 31, 2010 and 2009, respectively, and is recorded as a reduction of RUS long-term debt on the balance sheets.

**Environmental matters** – KIUC is subject to federal, state and local environmental laws. These laws regulate the discharge of materials into the environment and may require KIUC to mitigate the effects of a release of a hazardous substance. Environmental matters are recorded when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated. In general, costs related to environmental matters are charged to expense. Environmental costs are capitalized if the costs increase the value of the property and/or prevent or mitigate contamination from future operations. Although the level of future expenditures for environmental matters is difficult to determine, it is management's opinion that such costs when determined will not have a material adverse effect on KIUC's financial condition. Accordingly, no provision has been included in the accompanying financial statements.

**KAUA'I ISLAND UTILITY COOPERATIVE**  
**NOTES TO FINANCIAL STATEMENTS**

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**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (continued)**

**Concentration of credit risk** – Financial instruments that are exposed to concentrations of credit risk consist primarily of cash, including other investments, and receivables.

The Cooperative maintains its cash in deposit accounts in various financial institutions and its other investments in highly rated securities. At times these balances exceed federally insured limits.

Credit is extended to customers generally without collateral requirements; however, the Cooperative requires a deposit from some members upon connection, which is applied to unpaid bills and fees in the event of default. The deposit accrues interest annually and is returned along with accrued interest periodically. In addition, formal shut-off procedures are in place.

**Use of estimates** – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates include the allowance for doubtful accounts, unbilled revenue, overhaul deferrals, the post-retirement benefit obligation and depreciation of electric plant. Actual results could differ from those estimates.

**Subsequent events** – The Cooperative has evaluated subsequent events through April 14, 2011, the date the financial statements were available to be issued.

**NOTE 3 – ELECTRIC PLANT IN SERVICE**

The major classes of electric plant in service are as follows:

	<u>2010</u>	<u>2009</u>
Production plant	\$ 143,560,793	\$ 137,519,274
Transmission plant	72,593,896	71,311,838
Distribution plant	153,022,034	150,593,578
General plant	<u>26,846,929</u>	<u>25,673,959</u>
Total electric plant in service	<u>\$ 396,023,652</u>	<u>\$ 385,098,649</u>

**KAUA'I ISLAND UTILITY COOPERATIVE**  
**NOTES TO FINANCIAL STATEMENTS**

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**NOTE 4 - OTHER PROPERTY AND INVESTMENTS**

Other property and investments consisted of the following:

	<u>2010</u>	<u>2009</u>
Investments in associated organizations (CFC)		
Capital term certificates, interest from 0% to 7.5% maturing through 2044 or consistent with the related debt (See Note 8)	\$ 488,775	\$ 472,009
Patronage capital	119,122	104,100
Membership/other	<u>1,884</u>	<u>1,464</u>
	<u>\$ 609,781</u>	<u>\$ 577,573</u>
Rural economic development loans		
National Tropical Botanical Gardens	271,875	300,000
Island School	290,625	300,000
Hale Opio	<u>74,461</u>	<u>83,911</u>
	<u>636,961</u>	<u>683,911</u>
Total other property and investments	<u>\$ 1,246,742</u>	<u>\$ 1,261,484</u>

**NOTE 5 - INVENTORIES**

Inventories consisted of the following:

	<u>2010</u>	<u>2009</u>
Materials and supplies	\$ 12,794,598	\$ 11,732,716
Fuel	<u>1,422,800</u>	<u>1,587,725</u>
Total inventories	<u>\$ 14,217,398</u>	<u>\$ 13,320,441</u>

**KAUA'I ISLAND UTILITY COOPERATIVE**  
**NOTES TO FINANCIAL STATEMENTS**

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**NOTE 6 - DEFERRED DEBITS**

Deferred debits consisted of the following:

	<u>2010</u>	<u>2009</u>
Regulatory asset – Iniki damage	\$ 3,433,992	\$ 3,726,252
Regulatory asset – post-retirement transition	137,949	206,937
Regulatory asset – demand-side management (DSM) and integrated resource plan (IRP)	(51,933)	(158,278)
Regulatory asset – rate case	859,500	1,138,898
Preliminary survey and investigation	1,419,628	591,856
Other deferred debits	<u>536,154</u>	<u>383,865</u>
Total deferred debits	<u>\$ 6,335,290</u>	<u>\$ 5,889,530</u>

**NOTE 7 - PATRONAGE CAPITAL**

Patronage capital consisted of the following:

	<u>2010</u>	<u>2009</u>
Assigned	\$ 66,796,605	\$ 61,222,848
Assignable	<u>9,956,122</u>	<u>5,573,757</u>
	76,752,727	66,796,605
Less: Retired	<u>(16,997,071)</u>	<u>(15,480,297)</u>
Total patronage capital	<u>\$ 59,755,656</u>	<u>\$ 51,316,308</u>

**NOTE 8 - LONG-TERM DEBT**

The Cooperative has long-term debt due to Rural Utilities Services (RUS), National Rural Utilities Cooperative Finance Corporation (CFC) and the Federal Financing Bank (FFB). Substantially all assets of the Cooperative are pledged as security for the long-term debt and the notes are subject to certain covenants.

**KAUA'I ISLAND UTILITY COOPERATIVE**  
**NOTES TO FINANCIAL STATEMENTS**

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**NOTE 8 - LONG-TERM DEBT** - (continued)

Following is a summary of long-term debt:

	<u>2010</u>	<u>2009</u>
Fixed and variable notes payable due to RUS in monthly installments of principal and interest with rates ranging from 3.125% to 4.875%, maturing October 31, 2027.	\$ 175,908,136	\$ 182,894,997
Fixed and variable notes payable due to FFB in quarterly installments of principal and interest with rates ranging from 2.712% to 4.305%, maturing December 31, 2023.	26,221,746	27,746,361
Fixed note payable due to CFC in quarterly installments of principal and interest at a rate of 3.108%, maturing September 30, 2023.	5,806,223	6,169,510
RUS/FFB advance payments (cushion of credit)	<u>(10,154,516)</u>	<u>(15,114,758)</u>
Total long-term debt	197,781,589	201,696,110
Less current maturities	<u>(9,261,000)</u>	<u>(8,875,500)</u>
Long-term debt, less current maturities	<u><u>\$ 188,520,589</u></u>	<u><u>\$ 192,820,610</u></u>

Maturities of long-term debt for the next five years and thereafter are as follows:

2011	\$ 9,261,000
2012	9,661,075
2013	10,065,162
2014	15,369,827
2015	10,479,415
Thereafter	<u>142,945,110</u>
	<u><u>\$ 197,781,589</u></u>



**KAUA'I ISLAND UTILITY COOPERATIVE**  
**NOTES TO FINANCIAL STATEMENTS**

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**NOTE 8 - LONG-TERM DEBT - (continued)**

The carrying value for variable rate debt is considered fair value due to the frequency of repricing. The fair market value of the Cooperative's fixed rate long-term debt is determined using currently quoted or offered rates for similar issues.

	Carrying Value	Fair Value
	<u>                    </u>	<u>                    </u>
December 31, 2010	\$ 207,936,104	\$ 112,874,144
	<u>                    </u>	<u>                    </u>
December 31, 2009	\$ 216,810,868	\$ 108,053,864
	<u>                    </u>	<u>                    </u>

**NOTE 9 - LINE OF CREDIT**

The Cooperative has a perpetual \$85,000,000 line of credit for short-term financing with CFC at a variable interest rate. The line is secured by substantially all Cooperative assets and subject to termination provisions and certain covenants. There was no balance outstanding at December 31, 2010. The total balance outstanding was \$2,000,000 at December 31, 2009.

**NOTE 10 - DEFERRED CREDITS**

Deferred credits consisted of the following:

	2010	2009
	<u>                    </u>	<u>                    </u>
Rural economic development grant	\$ 920,539	\$ 918,961
Customer advances for construction	3,664,968	3,693,275
Regulatory liability - Iniki	3,433,992	3,726,252
Regulatory liability - Scheduled plant maintenance	1,608,775	2,041,814
	<u>                    </u>	<u>                    </u>
Total deferred credits	\$ 9,628,274	\$ 10,380,302
	<u>                    </u>	<u>                    </u>

## **KAUA'I ISLAND UTILITY COOPERATIVE**

### **NOTES TO FINANCIAL STATEMENTS**

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#### **NOTE 11 – LITIGATION, COMMITMENTS AND CONTINGENCIES**

##### **Litigation**

In March 2007, the Cooperative was notified by the Environment and Natural Resources Division of the U.S. Department of Justice that it was the target of an investigation into the taking of migratory birds. This investigation was conducted by the U.S. Fish and Wildlife Service in conjunction with the U.S. Department of Justice with the cooperation of the U.S. Attorney's office for the District of Hawaii. This suit was settled in December 2010 with the Cooperative paying a \$40,000 fine, making a \$225,000 donation and agreeing to approximately \$11 million in future mitigation efforts.

In the normal course of business, the Cooperative is a party to claims and matters of litigation. The ultimate outcome of these matters cannot presently be determined; however, in the opinion of management of the Cooperative, the resolution of these matters will not have a material adverse effect on the Cooperative's financial position, results of operations or liquidity.

##### **Fuel Contract**

As a result of the purchase of KE assets, Citizens assigned to KIUC a fuel supply contract with an international oil refining company that is renewable for 12-month periods unless terminated by KIUC or the supplier; 98.9% of KIUC's fuel is obtained through this supply contract. The price is adjusted monthly to equal a published price, as defined, plus other defined costs such as terminal and freight costs. Fuel costs under this contract for the years ended December 31, 2010 and 2009 were \$68,115,764 and \$51,741,645, respectively.

##### **Power Supply**

Most of KIUC's power is generated using diesel and naphtha generating units. In addition, KIUC maintains various power supply agreements to purchase excess power from hydroelectric projects. The terms of the agreements vary and include termination provisions.

In 2010, KIUC installed a 68 kW roof-integrated photovoltaic system on its Port Allen warehouse roof and two 175 kW utility pole mount photovoltaic systems. In 2011, KIUC will be installing 48 200 kW utility pole mount photovoltaic systems, 16 of which have already been installed.

In addition, during 2010 KIUC signed the following agreements:

- Kaua'i Farm Fuel, LLC to purchase biodiesel for use in the Stork Wartsila diesel engines. This contract has a term of 10 years.
- Kapaa Solar, LLC to purchase power from its 1.21 MW photovoltaic facility, which was completed in February 2011. This contract has a term of 20 years.
- Poipu Solar, LLC to purchase power from its proposed 3 MW photovoltaic facility, which is planned to be constructed in 2011. This contract has a term of 20 years.
- Green Energy Team, LLC to purchase power from its proposed 6.7 MW biomass-to-energy facility, which is planned to be constructed in 2013. This contract has a term of 20 years.

**KAUA'I ISLAND UTILITY COOPERATIVE**  
**NOTES TO FINANCIAL STATEMENTS**

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**NOTE 11 - LITIGATION, COMMITMENTS AND CONTINGENCIES - (continued)**

**Union Contract**

KIUC has an agreement with one union. In December 2010, the Cooperative negotiated a new contract with the union. As of December 31, 2010, 61% of the positions and employees were covered by the union contract. The agreement expires in December 2015.

**Operating Lease**

KIUC leases their headquarters under a non-cancelable operating lease which expires in 2020 and contains options to extend the term up to an additional 25 years. The lease also includes an option to purchase the landlord's interest, as defined, in the year 2025. As of December 31, 2010, the future minimum rental commitment under this lease is as follows:

2011	\$ 1,077,000
2012	1,077,000
2013	1,077,000
2014	1,077,000
2015	1,077,000
Thereafter	<u>5,100,000</u>
	<u>\$ 10,485,000</u>

In addition to the amounts above, the Cooperative is responsible for common area maintenance costs, real property taxes and other reimbursable operating expenses. Rent expense for the years ended December 31, 2010 and 2009 was \$1,402,512 and \$1,427,880, respectively.

**NOTE 12 - PENSION BENEFITS**

Substantially all employees of the Cooperative participate in the National Rural Electric Cooperative Association (NRECA) Retirement & Security Program (a defined benefit plan) and the 401(k) Savings Plan (a defined contribution plan). The plans are qualified as tax exempt under the Internal Revenue Code. In these multi-employer plans, which are available to all NRECA member cooperatives, the accumulated benefits and plan assets are not determined or allocated separately by the individual employer.

The Cooperative makes monthly contributions to the Retirement & Security Plan equal to the amounts accrued for pension expense. In response to impacts from the economic crisis, there was an increase in the required contribution rate in 2010 and 2009. The pension cost for the Cooperative for the years ended December 31, 2010 and 2009 was \$2,686,922 and \$1,951,736, respectively.

The pension cost for the 401(K) Savings Plan was \$488,334 and \$385,902 for the years ended December 31, 2010 and 2009, respectively.

## **KAUA'I ISLAND UTILITY COOPERATIVE**

### **NOTES TO FINANCIAL STATEMENTS**

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#### **NOTE 13 - POST-RETIREMENT BENEFITS**

The KIUC Retiree Welfare Benefit Plan (the Plan) and its associated trust, the KIUC Retiree Welfare Benefit Trust (the Trust), were adopted effective January 1, 2003. The Plan provides certain non-contributory medical (which includes a dollar cap, for which retirees pay back KIUC for amounts exceeding the cap), dental, vision and life insurance benefits for retired employees, their beneficiaries and covered dependents.

Benefits are paid on behalf of retirees and are a function of medical insurance costs and number of retirees. Benefits paid for the years ended December 31, 2010 and 2009 were \$303,849 and \$285,168, respectively.

The measurement date for the current valuation is December 31, 2010.

Assumptions:

The actuarial cost method used for the valuation is the projected unit credit cost method.

Weighted-average assumptions used to determine the net periodic benefit cost for year ended December 31, 2010:

- Discount rate: 6.0%
- Expected long-term return on plan assets: 2.25% (based on the five-year performance of the funds, weighted by market value as of December 31, 2009)
- Health care cost trend rate assumed for next year: 8.0%
- Rate to which the cost trend rate is assumed to decline (the ultimate trend rate): 5.0% in 2017

**KAUA'I ISLAND UTILITY COOPERATIVE**  
**NOTES TO FINANCIAL STATEMENTS**

**NOTE 13 – POST-RETIREMENT BENEFITS – (continued)**

	2010	2009
I) Net post-retirement benefit cost		
Service cost	\$ -	\$ -
Interest cost	297,500	303,100
Expected return on plan assets	(66,800)	(72,500)
Amortization of actuarial gain	(88,800)	-
	\$ 141,900	\$ 230,600
II) Accumulated post-retirement benefit obligation (APBO)		
APBO balance at the beginning of year	\$ (5,353,300)	\$ (7,471,300)
Other	(125,922)	2,040,900
Net post-retirement benefit cost	(141,900)	(230,600)
Benefits paid	364,322	307,700
	\$ (5,256,800)	\$ (5,353,300)
III) Reconciliation of funded status		
APBO	\$ (5,256,800)	\$ (5,353,300)
Assets funded	3,276,200	2,969,734
	\$ (1,980,600)	\$ (2,383,566)
IV) Accumulated other comprehensive (gain) loss		
Unrecognized prior service cost	\$ (890,634)	\$ 1,620,700
Other comprehensive loss	(150,866)	(2,511,334)
	\$ (1,041,500)	\$ (890,634)

**KAUA'I ISLAND UTILITY COOPERATIVE**  
**NOTES TO FINANCIAL STATEMENTS**

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**NOTE 13 - POST-RETIREMENT BENEFITS - (continued)**

The following benefit payments, which reflect expected future service as appropriate, are expected to be paid:

2011	\$	404,700
2012		402,800
2013		417,600
2014		423,300
2015		397,700
2016 - 2020		1,863,900

The Plan has been partially funded as of December 31, 2010. The Plan assets are held in the Trust and are invested in the Central Pacific Bank's Trust Division at December 31, 2010.

The Plan assets are managed by a trustee and are authorized to be held in various equity and fixed income investments and cash equivalents. The trustee is not allowed to invest in real estate or any other investment other than those noted in the investment policy. The investing strategy is long term with a focus on moderate volatility and moderate growth investments. All investments at December 31, 2010 were level one investments as outlined in the fair value hierarchy as they have quoted prices in active markets for identical assets. The following table shows the investment allocation for Plan assets.

	2010		2009			
Cash and other accrued income	\$	5,143	0%	\$	10,172	0%
Mutual funds		3,123,567	95%		1,083,771	37%
Bonds		147,821	5%		901,075	30%
Equities		-	0%		974,716	33%
Due to brokers		(331)	0%		-	0%
		\$ 3,276,200			\$ 2,969,734	

**NOTE 14 - SUBSEQUENT EVENT**

On March 29, 2011, KIUC Board of Directors entered into agreements with Free Flow Power (FFP) to pursue the joint development of several small hydroelectric projects proposed for the island of Kaua'i. Under the terms of the agreements, FFP has transferred ownership of six hydroelectric development projects to KIUC. Under a separate agreement, FFP will be providing development services to KIUC with regard to these projects. The Development Services Agreement has a range of commitments based on the achievement of certain milestones.

**REPORT REQUIRED BY GOVERNMENT AUDITING STANDARDS**

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**INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS***

To the Board of Directors  
Kaua'i Island Utility Cooperative

We have audited the financial statements of Kaua'i Island Utility Cooperative (the Cooperative) as of and for the year ended December 31, 2010 and have issued our report thereon dated April 14, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Internal Control Over Financial Reporting**

In planning and performing our audit of the financial statements of Kaua'i Island Utility Cooperative (the Cooperative) as of and for the year ended December 31, 2010, in accordance with auditing standards generally accepted in the United States of America, we considered the Cooperative's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Cooperative's internal control. Accordingly, we do not express an opinion on the effectiveness of the Cooperative's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Cooperative's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.



MOSS ADAMS<sub>LLP</sub>

We noted certain matters that we reported to the Cooperative's Board of Directors and management in a presentation.

This report is intended solely for the information and use of the Board of Directors, management, the Rural Utilities Service and supplemental lenders and is not intended to be and should not be used by anyone other than these specified parties.

Moss Adams LLP

Portland, Oregon  
April 14, 2011